



THE CLEARING HOUSESM
Advancing Payment Solutions Worldwide

Jeffrey P. Neubert
President and CEO

100 Broad Street
New York, NY 10004
tele 212.612.9203

jeffrey.neubert@theclearinghouse.org

November 17, 2003

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th & Constitution Avenue, N.W.
Washington, D.C. 20551

Attention: Docket Nos. R-1156, R-1162

Public Information Room
Office of the Comptroller of the Currency
Mailstop 1-5
250 E Street, S.W.
Washington, D.C. 20219

Attention: Docket Nos. 03-21, 03-22

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Attention: Comments/OES

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552

Attention: Nos. 2003-47, 2003-48

Re: Interim Capital Treatment of Consolidated Asset-Backed
Commercial Paper ("ABCP") Program Assets and
Notice of Proposed Rulemaking Regarding ABCP Programs
and Early Amortization Provisions

Ladies and Gentlemen:

The New York Clearing House Association L.L.C. ("The Clearing House"), an association of major commercial banks¹, appreciates the opportunity to comment on the interim final rule ("Interim Final Rule") regarding the capital treatment of ABCP program assets and the notice of proposed rulemaking ("NPR") regarding ABCP programs and early amortization provisions recently published by the Board of Governors of the Federal Reserve System (the

¹ The members of The Clearing House are Bank of America, National Association, The Bank of New York, Bank One, National Association, Citibank, N.A., Deutsche Bank Trust Company Americas, Fleet National Bank, HSBC Bank USA, JPMorgan Chase Bank, LaSalle Bank National Association, Wachovia Bank, National Association, and Wells Fargo Bank, National Association.

“Board”), the Federal Deposit Insurance Corporation (the “FDIC”), the Office of the Comptroller of the Currency (the “OCC”) and the Office of Thrift Supervision (the “OTS”) (together, the “Agencies”).

We commend the Agencies for their swift response to the implementation of the Financial Accounting Standards Board’s Interpretation No. 46 (“FIN 46”) on banking organizations’ risk-based capital calculations. The ramifications of FIN 46 for banking organizations’ Tier 1 and total capital ratios, if left unaddressed, would be inappropriate and significant. This is a critical area of concern for all banking organizations and we applaud the Agencies’ efforts to address the consequences of the change in the accounting treatment of variable interest entities (“VIEs”) resulting from FIN 46. We also generally support both the Agencies’ view that regulatory capital should in many circumstances be maintained against 364-day or less ABCP liquidity facilities and the substance of the NPR’s approach to an early amortization capital charge for securitizations of retail credit exposures. However, we believe the substance of the ABCP liquidity proposal requires revision. As to the early amortization capital charge for securitizations of retail credit exposures, we urge the Agencies to coordinate their proposal, as to substance and timing, with the implementation of the new capital accord of the Basel Committee on Banking Supervision (“BIS II”).

We have set forth below our specific comments on the Interim Final Rule and on the NPR.

I. Interim Final Rule

While the interim final rule appropriately affords banking organizations at least temporary risk-based capital relief against ABCP program assets that may be required to be consolidated under FIN 46, there is a lack of clarity and an apparent unintended inconsistency among the Agencies’ regulations as to the types of commercial paper vehicles covered by the rule.

More specifically, the Agencies have not defined an “asset-backed commercial paper program” in exactly the same way in their respective regulations, as implemented on an interim basis in the Interim Final Rule and as proposed to be made permanent in the NPR. We understand, however, that the Agencies intend for structured investment vehicles (“SIVs”) to be eligible for the risk-based capital relief applicable to “ABCP programs.” Unfortunately, the definitions of “asset-backed commercial paper program” proposed by the Board and the FDIC are ambiguous and could be read to exclude SIVs. We therefore urge the Agencies to remedy this inconsistency and uncertainty, in order to prevent possible future misinterpretations.

SIVs are entities that issue long-term capital notes and short-term funding instruments (*e.g.*, commercial paper and medium-term notes) and use the proceeds to purchase investments in highly-rated debt securities. SIVs are required to operate within a number of prescribed limits and tests specified by rating agencies. Although SIVs typically have more

funding alternatives available to them than traditional ABCP programs, SIVs are conduits that present, for a banking organization holding an SIV's capital notes and/or acting as the portfolio/investment manager or sponsor of an SIV, a similar risk profile as for a banking organization acting as sponsor of an ABCP program. That is, the risks associated with an SIV are dispersed among its capital noteholders based upon their ownership amounts. Consequently, SIVs consolidated by a banking organization as a result of the application of FIN 46 should be subject to the same regulatory capital treatment as other ABCP programs.

We suggest the following definition of "asset-backed commercial paper program" to address this issue:

"Asset-backed commercial paper program" means a commercial paper conduit, structured investment vehicle or other program that, in each case, issues commercial paper backed by assets or other exposures held in a bankruptcy-remote special purpose entity.

II. Notice of Proposed Rulemaking

A. *ABCP Programs – Treatment of Liquidity Facilities*

The Agencies have proposed to require that liquidity facilities to ABCP programs meet certain tests in order for the liquidity facility not to be considered a recourse obligation or direct credit substitute, and to be eligible for the 20% (proposed for facilities with original maturities of one year or less) or 50% (already in effect for facilities with original maturities of more than one year) credit conversion factors for determining the facility's on-balance sheet credit equivalent amount. Such an "eligible liquidity facility" is defined by the NPR as being one in which draws under the facility are subject to a reasonable asset quality test that precludes funding of assets 60 days or more past due or in default.

Given the continuing consideration and revision of BIS II and its framework, we recommend that the Agencies re-consider the conversion factors proposed in the NPR to make them consistent with the BIS II requirements. Based upon the strength of the credit risk profile of the liquidity facilities, we believe a lower conversion factor than 20% would be appropriate in most cases. In addition, we do not believe that the asset quality test proposed for liquidity facility draws for transactions with rated assets is appropriate.

Specifically, while The Clearing House members believe that it is appropriate to maintain some regulatory capital against ABCP liquidity facilities having an original maturity of one year or less, mandating a 20% credit conversion factor for such facilities would result in a risk-based capital charge which is excessive relative to the historical credit loss experience of banking organizations with these facilities. We note that others in the industry have proposed a 5% – 10% credit conversion factor for such short-term liquidity facilities as a more risk sensitive and appropriately calibrated proxy for the credit risk truly inherent in these exposures. We

strongly support this view. Moreover, it is important to note that adoption of the proposed 20% credit conversion factor for short-term liquidity facilities would create competitive inequities for U.S. banking organizations, not only with non-U.S. competitors but also with other non-bank providers of corporate funding within the U.S.

Additionally, apart from the proper credit conversion factor to be applied to short-term ABCP liquidity facilities, we believe that the definition of an “eligible liquidity facility” should be more flexible and incorporate asset quality tests that vary based upon the specific transaction structures or underlying asset types. In our view, the generic “reasonable asset quality test” established in the NPR’s proposed definition of “eligible liquidity facility” would not appropriately assess credit risk or set appropriate risk-based capital requirements for liquidity facilities. Instead, we recommend that the Agencies replace the NPR’s proposed definition of “eligible liquidity facility” with a requirement that each bank seek approval from its primary regulator for reasonable asset quality tests specific to the ABCP programs sponsored by that bank. This is essentially an “internal models” approach similar (i) to that applied by the Agencies in the market risk capital requirements and in some circumstances involving recourse obligations and direct credit substitutes for ABCP programs and (ii) to the internal ratings based approach for credit risk contemplated by BIS II.

We believe the characteristics of the ABCP program market support our proposal. There are significant variations in the underlying terms and characteristics of various ABCP programs. These differences are driven primarily by asset type and transaction type, and, in certain cases, by the practices and policies followed by the sponsoring bank with respect to its ABCP program liquidity facilities. Generally, under ABCP program liquidity facility agreements, the liquidity provider purchases specific underlying ABCP conduit assets at a set price upon the occurrence of defined events. The purchase price to be paid is determined by reference to certain credit-related terms or “triggers” set forth in the liquidity facility agreement.

Credit-related triggers that are used to determine the purchase price for a particular ABCP conduit asset vary according to the specific transactions and the underlying asset pool characteristics. Generally, credit-related triggers can be classified as one of two types: ratings based triggers or cash flow/financial benchmark triggers. Each of these types of credit-related triggers has unique characteristics, and both exist in industry practice.

Ratings based purchase price adjustment triggers in liquidity facility agreements can be based on the credit rating of the underlying seller, the transaction itself² (if externally rated), or the transaction guarantor. Cash flow/financial benchmark purchase price adjustment triggers in liquidity facility agreements are based on key financial performance benchmarks of

² For example, certain types of conduits often purchase investment securities that are externally rated on a transaction basis.

the underlying asset pool, including cash flow performance measures such as days past due or delinquent payments.

For cash flow/financial benchmark triggers, where delinquent cash flow benchmarks are used, different underlying asset types have very different charge off/delinquency standards. For example, trade receivable pool transactions may have a 60-day or 90-day charge off/delinquency standard, and credit card receivable pool transactions generally have a charge off/delinquency standard of between 120 and 180 days.³

Regarding the asset quality test set forth in the NPR, we do not believe that the limitation that prohibits liquidity facility draws for transactions where the rating of the assets falls below investment grade is appropriate. Such a requirement is irrelevant for non-ratings-based triggered transactions where the asset quality is determined using cash flow or other benchmarks. Further, we note that all cash flow and ratings based purchase price triggers are in place to adjust the purchase price of the asset pool underlying the liquidity facility to ensure that any credit risk of the underlying asset pool is incorporated into the amount of the draw, thereby making the investment grade requirement unnecessary. We therefore suggest that the Agencies delete this limitation.

Consequently, instead of the standardized requirements proposed in the NPR, we recommend that the final rule allow each bank to establish with its primary regulator an asset- and structure-specific reasonable asset quality test for determining whether that bank's liquidity facilities are "eligible liquidity facilities." Such a bank-specific test would be based on that bank's ABCP program liquidity facility programs and would incorporate industry practice for assessing credit quality in ABCP program liquidity facilities. We believe that this method of evaluating risks to banks related to their particular liquidity facilities would more accurately assess the banks' exposure and better achieve the Agencies' goal of implementing a risk-sensitive approach to the exposures arising from ABCP programs.

B. Liquidity Facilities Held in Trading Accounts

The Clearing House member banks understand that the Agencies' are concerned about potential arbitrage of the risk-based capital rules in connection with the proposed credit conversion factor for short-term liquidity facilities related to ABCP programs. The Agencies have explicitly addressed this concern in the NPR by proposing to amend their respective market risk capital rules to require generally that liquidity facilities in favor of ABCP programs held in

³ We note our view that an arbitrary cut-off at the 60-day delinquency level in the case of credit card receivable pool transactions would significantly overstate the risk of default, as the amount of credit cards that ultimately charge-off between 120 and 180 days is typically far less than the amount that are 60 days delinquent.

the trading account be excluded from coverage under the market risk capital rules and instead be subject to capital requirements under the credit risk capital rules.

This change poses several serious concerns, and The Clearing House member banks believe it is inappropriate and unwarranted. First, the Agencies' proposal ignores U.S. GAAP accounting decisions with respect to the trading book classification of individual transactions by prohibiting application of the market risk capital rules and mandating use of the credit risk capital rules. The proposed approach would effectively reclassify these transactions to the banking book, notwithstanding that the Call Report instructions typically require that they be carried in the trading book. Accordingly, implementation of this proposal would establish a precedent whereby in the future the Agencies could incrementally revise for certain products their risk-based capital treatment, which derives from the accounting decisions made with respect to those products, and thus potentially undermine business decisions related to other products carried in the trading book.

Second, we note that there already exists a well-defined mechanism for assessing capital in the trading book. Namely, the market risk capital rules distinguish the capital (the specific risk component) required for liquid/rated as opposed to illiquid/unrated exposures held in the trading book. The specific risk component capital charge for an illiquid/unrated exposure is the same as under the credit risk capital rules, whereas rated exposures are appropriately analyzed in a more risk-sensitive calibration than under the credit risk capital rules. Additionally, the mark-to-market accounting discipline applied to trading positions (cash or synthetic), combined with individual banking organizations' market value adjustment process (the component that addresses illiquidity or pricing uncertainty), assures that capital is adequately reserved on a "real-time" basis. To not use all of these regulatory and conventional mechanisms for assessing the appropriate amount of capital for market pricing risk, and instead to arbitrarily default to the credit risk capital rules, is not justified as an analytic matter or by the low level of risk that providers assume in connection with these products and in practice could dissuade U.S. banking organizations from offering products such as deep out-of-the-money liquidity options, which embody positive risk/return features.

Additionally, the Agencies' apparent focus on ABCP programs in which the underlying assets consist of unrated corporate trade receivables is much too narrow. Although the Agencies acknowledge that some programs may hold marketable assets such as rated asset-backed securities, we believe that the risk profile of programs that hold rated corporate bonds has not been adequately considered. We are very concerned about the anomaly this will create: the Agencies' example would lead to the conclusion that a very small capital charge will result if the assets are highly rated when, in fact, a liquidity facility for a program whose underlying assets are AAA-rated corporate bonds would be assigned the highest credit risk weighting as if the underlying assets were unrated and illiquid.

Finally, the NPR does not include a definition of “liquidity facilities.” The Board and the FDIC each provide in the proposed amendments to their respective market risk capital rules that positions in the bank’s trading account that “in form or in substance” act as eligible liquidity facilities to ABCP programs would be subject to the credit risk capital rules. We believe that this creates a framework that is too broad and will be impractical to implement. We strongly urge that each of the Agencies remove the prohibition against use of the market risk capital rules for derivatives and other similar arrangements with ABCP programs that may be “deemed” eligible liquidity facilities, and that are appropriately held in the trading book under U.S. GAAP accounting. We respectfully submit that regulatory capital should be determined in the same way for the same risks in the trading book whether the transaction is a cash position (funded) or a derivative with a single counterparty or a commercial paper issuer (unfunded). That is, there should not be significantly different regulatory capital results simply by indirectly assuming the same risks that could be assumed directly.

However, if the Agencies determine that the approach proposed in the NPR is appropriate, the exclusions from covered positions under the market risk capital rules should be narrowed. At a minimum, we strongly urge the Agencies to adopt a uniform standard that conforms to the standard proposed by the OCC. We understand that the Agencies may wish to prevent “plain vanilla” liquidity facilities traditionally present in ABCP programs from being treated as trading positions. We note, however, that there can be other, highly-structured derivative products related to various types of ABCP programs that may be appropriately treated as trading positions. We are very concerned that the treatment proposed in the NPR will too readily prescribe an unjustified credit risk capital treatment for such products.

Specifically, we propose that banking organizations be permitted to leave in the trading book for regulatory capital purposes (and apply the market risk capital rules to) liquidity facilities or arrangements that satisfy the following criteria:

1. The arrangement with the ABCP program must be documented in legal form as a derivative, part of a documented trading strategy, treated for risk management purposes as a trading position and treated as a trading account transaction for U.S. GAAP accounting purposes.⁴
2. The purpose of the derivative or other arrangement must be to provide (i) interest rate hedging, (ii) foreign exchange rate hedging, and/or (iii) market price protection on issued commercial paper which requires funding only upon remote price movements caused by a general disruption in the commercial paper markets.

⁴ This would require that changes in value be marked-to-market through P&L and therefore be reflected immediately in regulatory capital.

3. There must be an independent credit support, either direct or indirect, in the overall arrangement.
4. The underlying assets and/or the related liabilities (*i.e.*, the commercial paper) must be eligible for inclusion in the trading book.

We do not expect to achieve a zero regulatory capital charge in the trading book for these derivatives positions, but we believe it is inappropriate to take a full credit risk capital charge given that structural elements of the transactions make potential risk of credit losses a remote possibility. We believe that this would be more than adequately achieved by the mark-to-market, the trading book risk management and the market risk capital processes.

C. Early Amortization Capital Charge

The Clearing House members recognize and support the Agencies' efforts to take a more risk-sensitive approach by tiering the risk-based capital charges in the NPR's proposal with respect to an early amortization charge for securitizations of retail credit exposures. This is superior to the past proposals on this topic. For banking organizations with significant securitized retail credit exposures, this is a critically important issue, the scope of which is not limited to operations in the United States. Therefore, although we agree with the direction the Agencies have taken in the NPR, we strongly urge the Agencies not to address this issue in regulations adopted pursuant to the NPR but instead to coordinate their requirements for an early amortization capital charge with the implementation of BIS II, both as to substance and timing of implementation. The risk of inconsistent or contradictory guidance in this area is too great, and the effects too far reaching, to justify adopting any new regime in this area in advance of the implementation of BIS II. Furthermore, we do not understand the urgency of adding risk-based capital requirements to the existing charges on these transactions given that these securitization structures generally are assessed risk-based capital currently under the Agencies' recent securitization and recourse rules.

*

*

*

Jennifer J. Johnson, Federal Reserve System
Robert E. Feldman, Federal Deposit Insurance Corporation
Office of the Comptroller of the Currency
Office of Thrift Supervision

9

Thank you for considering the views expressed in this letter. We would welcome the opportunity to meet with you in person if you would find that to be useful. If you have any questions, please contact Norman R. Nelson, General Counsel of The Clearing House, at 212-612-9205.

Sincerely yours,

A handwritten signature in dark ink, appearing to read "J. French", with a long horizontal stroke extending from the bottom of the signature.

cc: Norah Barger
Deputy Associate Director
Board of Governors of the
Federal Reserve System

George French
Deputy Director
Division of Supervision and Consumer Protection
Federal Deposit Insurance Corporation

Tommy Snow
Director, Capital Policy
Office of the Comptroller of the Currency

John C. Price
Director, Supervision Policy
Office of Thrift Supervision